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The Evolution of Policy Capacity in the Financial Sector

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Governing Global Risks: The Evolution of Policy Capacity in the Financial Sector

Louis W. Pauly[1]

Abstract

Despite the fragility of authoritative governing institutions at the international level, the political capacity to deal with global risks is developing. The sense of legitimacy that will ultimately derive from a deeply transnational sense of shared fate continues to lag, but even in that regard a process of progressive development is underway. Such an argument becomes defensible after the relationship between risk and uncertainty is understood, after the dynamic interaction of political conflict and functional spillovers is examined, and especially after distinctions are made among the variegated politics of risk measurement and assessment, of compensation and prevention, and of management and resolution. After outlining such conceptual issues, the plausibility of the argument is probed here in a most sensitive arena of contemporary policy-making, namely in the political economy of well-functioning global financial markets. The experience of international crisis management around the year 2008 is especially illuminating. The building of global policy capacity in this arena is a reversible process, but the circumstances under which such a reversal might occur are becoming increasingly implausible.

Keywords: global risks, uncertainty, financial governance, crisis management

Zusammenfassung

Trotz der Fragilität autoritativer Governance-Institutionen auf internationaler Ebene ist die Fähigkeit der Politik zum Umgang mit globalen Risiken in der Entwicklung begriffen. Der Glaube an die Legitimität dieser Institutionen, der sich letztlich aus einem zutiefst transnationalen Verständnis eines gemeinsamen Schicksals ableiten wird, bleibt bisher zwar hinter diesem Prozess zurück, befindet sich aber ebenfalls in einer fortschreitenden Entwicklung. Um dieses Argument überzeugend vertreten zu können, muss zunächst die Beziehung zwischen Risiko und Unsicherheit nachvollzogen sowie die dynamische Interaktion von politischem Konflikt und funktionalem Spill-Over untersucht werden. Zudem ist es erforderlich, die Unterschiede zwischen den vielfältigen Politiken der Risikomessung und -abschätzung, der Kompensation und Prävention sowie des Managements und der Problembewältigung herauszuarbeiten. Nach Skizzierung dieser konzeptionellen Fragen soll die Plausibilität des Arguments anhand eines der wohl sensibelsten Bereiche gegenwärtiger Politikgestaltung überprüft werden – der politischen Ökonomie gut funktionierender globaler Finanzmärkte. Dabei sind die Erfahrungen im Bereich des internationalen Krisenmanagements um das Jahr 2008 besonders aufschlussreich. Die Schaffung globaler

[1] This paper was written during my time as the Karl W. Deutsch Guest Professor at the WZB. I am grateful to Jutta Allmendinger and the administration of the Center, and especially to Michael Zürn, Director of the Global Governance Research Unit. He and his inspiring young colleagues and students have contributed much to my work. For many kinds of vital assistance, I also acknowledge with gratitude Editha Colberg, Patricia Löffler and Barçın Uluışık. The paper builds on a longstanding collaborative project with Edgar Grande. The related research of Bernhard Zangl, Steven Bernstein, and Matthew Hoffmann continues to shape that project. For comments, in addition to my colleagues in Berlin, I thank Charles Goodhart as well as David Vines, Russell Kincaid, Kalypso Nicolaïdis, and participants in a seminar in Max Watson's Political Economy of Financial Markets Programme at St. Antony's College in Oxford University on May 15, 2014.

politischer Kapazitäten in diesem Bereich stellt zwar einen reversiblen Prozess dar, aber die Umstände, unter denen eine derartige Umkehrung stattfinden könnte, erscheinen zunehmend unwahrscheinlich.

Schlüsselwörter: globale Risiken, Finanzgovernance, Krisenmanagement

I. Introduction

Risk, the probability of contingent harm, defines the modern human condition.[2] Estimating such probabilities, taking measures to reduce risks and avoid associated harms, but also putting in place instruments for managing the effects of harms that nevertheless occur—all are basic elements in the life of functioning communities, and therefore essential to the survival of their members. In such communities, individual and collective interests both shape and are shaped by an undeniable sense of shared destiny. Politics, the struggle over the distribution of the costs and benefits of communal decision or indecision, creates the capacity to deal with risks. Political conflict, however, can expand or erode the sense of shared destiny necessary to maintain it.
We might expect global risks--like the risks associated with climate change, nuclear energy production, the proliferation of high-technology weaponry, and systemic financial shocks--to stimulate similar reactions beyond the confines of established and bounded communities. Someday the most ambitious aspirations of communitarian theorists in this regard may be realized. Until then, there exists no unambiguous capacity to design and implement final risk assessment, compensation/prevention, and resolution strategies. Nevertheless, the incipient capacity to deal with global risks is becoming visible, even as its fundamental durability remains in question. This paper sets the conceptual groundwork for making and defending such an argument in a most sensitive area of contemporary policy-making, namely with regard to the foundational policies that must ultimately underpin well-functioning global financial markets.

II. Political authority and policy capacity in the face of global risks

Ulrich Beck long ago drew attention to mounting challenges facing humanity created not by nature but by our own ingenuity.[3] Given the current structure of the world's markets and politics, he hoped that thinking through their implications would move us all beyond the physical, psychological, and methodological boundaries of nations and nationalism. His intuition that considering the limits of conventional insurance schemes would help erode such boundaries lies behind this paper. To the extent we human beings have actually created new risks, they are in-principle insurable, including by the most ancient insurance scheme conventionally called 'gov-

[2] Richard V. Ericson and Aaron Doyle, *Uncertain Business: Risk, Insurance and the Limits of Knowledge*, Toronto: University of Toronto Press, 2004.

[3] Ulrich Beck, *Risk Society. Towards a New Modernity*, London: Sage, 1992; *The Reinvention of Politics. Rethinking Modernity in the Global Social Order*, Cambridge: Polity Press, 1997; *What is Globalization?* Cambridge: Polity Press, 2000; *World at Risk*, Cambridge: Polity Press, 2009; and Beck and Edgar Grande, *Cosmopolitan Europe*. Cambridge: Polity Press, 2007.

ernment.'[4] If we are in the realm of risk, we are in the realm of probability and rational estimation, but uncertainty is always in the background. The kinds of fundamental risks Beck emphasized reflect a high degree of 'manufactured' uncertainty that complicates such estimations and the measures needed to deal with them. Whether some or all global risks can in some way be rendered more manageable by insurance schemes is therefore an empirical and political question. For scholars of global governance, the challenge of conceptualizing responsive practices requires making an essential distinction between political authority--the right to govern, and policy capacity--the ability to govern.

The research agenda is huge, and this paper is not. On a broad and interdisciplinary analytical canvas, and as part of a larger project Edgar Grande and I now have underway, it focuses on one important aspect of a 'hard' case where the authority legitimately to manage and limit global risks is highly contested. My target is policy capacity in the arena of global finance, including but not limited to the capacity to design and implement insurance-like mechanisms. That target lies at the intersection of functional spillover and political conflict. The basic argument is that such a capacity is developing globally in the financial sector across the spectrum of measurement and assessment, compensation and prevention, and finally management and resolution, and that the issue of its legitimation becomes more tractable when we understand the different kinds of politics involved across that spectrum.

The Governance Problem

A transformation in political authority arguably occurs in three steps: the building of policy capacity (or power as it is commonly understood), the effective deployment of that capacity (or the actual solving of problems), and then the legitimation of that deployment (or wide-enough social acceptance that renders that capacity sustainable). Here, I take my cue from the political philosopher Thomas Nagel, who rejects the common view that legitimation needs to come first and only then can we affirm the emergence of political authority.[5] To use the language of international relations,

[4] For solid conceptual as well as empirical reasons, Charles Tilly, evoking Thomas Hobbes and the ancients, put protection schemes at the center of his famous paper, "War-making and state-making as organized crime," in Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol, *Bringing the State Back In*, Cambridge: Cambridge University Press, 1985, pp. 169-191.

[5] "While it is conceivable in theory that political authority should be created in response to an antecedent demand for legitimacy, I believe this is unlikely to happen in practice. What is more likely is the increase and deployment of power in the interests of those who hold it, followed by a gradual growth of pressure to make its exercise more just, and to free its organization from the historical legacy of the balance of forces that went into its creation. Unjust and illegitimate regimes are the necessary precursors of the progress toward legitimacy and democracy, because they create the centralized power that can then be contested, and perhaps turned in other directions without being destroyed. For this reason, I believe the most likely path toward some version of global justice is through the creation of patently unjust and illegitimate global structures of power that are tolerable to the interests of the most powerful

problem-solving can occur in an imaginable policy space that ranges from autonomous national action to intergovernmental coordination to supranational governance. When it does, an effective capacity is developing even if its legitimacy remains in question.[6] The weight of the evidence sketched below supports the hypothesis that such a capacity is now evolving quite rapidly in a policy arena defined by financial risks and uncertainties. Since that capacity turns on fiscal policy, the traditional non-military core of state sovereignty, its emergence is puzzling in a world still prizing communal autonomy. For the same reason, the legitimation of that capacity remains problematic.

Beck's much-cited image provides a starting point for analysis. Generated by human agency, global risks spill over conventional political boundaries. For this reason as well as the contested nature of the harms they evoke, they actually render opaque conventional distinctions between risks and uncertainties.[7] When we think about them, we think about the prospect of a socially constructed catastrophe, potentially but not easily pinned down in probabilistic terms. Full and reliable datasets for straightforward statistical calculations are not available. Even so, contemplating such catastrophes leads Beck to imagine a new kind of global politics that might render them more manageable. Contemporary proponents of 'global democracy' make the same imaginative leap.

'Global risk' has by now actually become a term of art suggesting avoidable catastrophes in the zone between readily calculable risks and not-quite-ineffable uncertainties. The term also brings to mind the borderlands between effective and legitimate governing systems. They are characterized by the complexity of dilemmas needing to be addressed and by the magnitude of the emergencies plausibly imaginable.[8] Consider, for example, the risks associated with nuclear power plants or esoteric financial derivatives. They are at least in principle calculable, but they are surrounded by various uncertainties that are difficult to unravel or that may take very long periods of time to become clear enough for informed speculation. Still, the events they portend very high losses that

current nation-states. Only in that way will institutions come into being that are worth taking over in the service of more democratic purposes, and only in that way will there be something concrete for the demand for legitimacy to go to work on." Thomas Nagel, "The Promise of Global Justice," *Philosophy and Public Affairs*, vol. 33, no. 2, March 2005, p. 147.

[6] The topic is a perennial and important one in political science and political sociology. A particularly vibrant research program is now underway on the legitimacy of international organizations, which is one instrument for potentially delivering effective governance. Thomas Franck, *The Power of Legitimacy Among Nations*, New York: Oxford University Press, 1990; Ian Hurd, "Legitimacy and Authority in International Politics," *International Organization*, vol. 53, no. 2, 1999, pp. 379-408; Allen Buchanan and Robert Keohane, "The Legitimacy of Global Governance Institutions," *Ethics and International Affairs*, vol. 20 no. 4, 2006, pp. 405–437; Steven Bernstein and William Coleman, eds., *Unsettled Legitimacy: Political Community, Power, and Authority in a Global Era*, Vancouver: University of British Columbia Press, 2009; Steven Bernstein, "Legitimacy in Intergovernmental and Non-State Global Governance," *Review of International Political Economy*, vol. 18 no. 1, 2011, pp. 17–51; and Jonas Tallberg and Michael Zürn, "The Legitimacy and Legitimation of International Organizations," orienting paper for a major collaborative research project, Wissenschaftszentrum Berlin für Sozialforschung, January 2014.

[7] Stephen C. Nelson and Peter J. Katzenstein, "Uncertainty, Risk, and the Financial Crisis of 2008," *International Organization*, vol. 68, pp 361-392.

[8] On the ways risks are perceived by individuals, the differences in such perception across groups, and the psychological short-cuts individuals and groups take in making decisions under conditions of risk and uncertainty, see, inter alia, Paul Slovic, ed., *The Perception of Risk*, London: Earthscan, 2000.

cannot reasonably justify passivity.[9] In such contexts where the probability of disaster is low but its potential cost extravagantly high, the possibility of eliminating risks and clearing up uncertainties in the near term is an illusion. The challenge is to govern such risks against the backdrop of uncertainty.[10]

What do I mean by 'governing' risks? I mean estimating and assessing them, seeking to prevent the harms they evoke, and managing and resolving emergencies when prevention fails. All of these tasks involve distributing associated costs--with finality. Effective and sustainable risk governance thus entails recognition, prudence, and legitimacy.

Risk, Uncertainty, and Insurance

Measuring, reducing, and pooling risks *ex ante*, as well as providing compensation *ex post*, describe the basic principles of insurance systems. Given shared expectations concerning outcomes and practical mitigation efforts, the more people who share, say, the risk of earthquakes, the cheaper will be their own protection costs and the lower will be their portion of the collective burden if an earthquake does occur. What about 'global' risks that by their nature are still shrouded by uncertainties but may plausibly be understood to extend beyond the jurisdiction and established capacities of particular societies? The scale of the dangers threatened means that above a certain threshold such risks can over-stretch the language of insurance. There exists no private firm or public agency authorized or able on its own to create big enough risk pools to manage them. When the disasters they estimate actually occur, the losses simply fall where they may.

The difficulty of imagining more adequate coverage for global risks, nevertheless, need not be an analytical end-point, nor should the assumption of uninsurability. Even as we begin to cross borders and zones of uncertainty, the language of insurance can still be helpful as a clarifying tool. Indeed, it can be more than that if it is empirically true that actual insurers are sometimes willing to provide cover for risks they do not fully understand.[11]

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[9] Charles Perrow has made the case most clearly for nuclear power. *Normal Accidents: Living with High-Risk Technologies*. Princeton, N.J.: Princeton University Press, 1999. But note the counter-argument of Todd La Porte and others related to the prospect of developing high-reliability organizational responses. "High Reliability Organizations: Unlikely, demanding, and at risk". *Journal of Contingencies and Crisis Management* 63(4), 2006; Todd R. La Porte and Paula Consolini, "Working in practice but not in theory: Theoretical challenges of High-Reliability Organizations" *Journal of Public Administration Research and Theory* 1, 1991, 19–47; and Todd R. La Porte and Gene Rochlin, "A rejoinder to Perrow." *Journal of Contingencies and Crisis Management* 2(4), 1994.

[10] For a comprehensive overview of sociological approaches to this challenge, see Ortwin Renn, *Risk Governance: Coping with Uncertainty in a Complex World*, London: Earthscan, 2008.

[11] The historically well-supported idea that the provision if insurance is, at root, a speculative enterprise suggests exactly that. In that regard, let me paraphrase an executive from a major international insurance firm. 'Uncertainty is

At the heart of all insurance systems are practices of burden sharing. Robinson Crusoe's survival would be most improbable in the non-fictional world. Only communities reliably sustain human life. Over time, real communities expand the bonds of solidarity to 'cover' larger and larger group risks. Where fires once wiped out whole cities and left bankruptcy in their wake, insurance and reinsurance firms now spread the risks of catastrophic fire far beyond city limits. And when those firms lose their bets that a fire will not occur, they also spread the losses and provide resources for recovery. True, they sometimes go bankrupt and do not pay out. Cross-border insurance markets today, however, are effective, broad, and deep, even if access to them remains unevenly distributed throughout the world.

Where conventional insurance schemes reach their limits, the nation-state has sometimes proven successful in expanding the boundaries of risk governance.[12] From Bismarck's day to our own, it has sometimes done so *ex ante* through mandatory risk pooling and public subsidy, and sometimes *ex post* by covering losses actually incurred. After 9-11, for example, the risk of global terrorism was taken out of many insurance and reinsurance policies. When subsequent incidents occurred, losses may or may not have been covered in whole or in part by particular governments, all of which could be expected to look first, and perhaps only, after their own citizens. In such cases, the limit has usually been defined by the fiscal capacity of the state, that is, the ability of organizations acting in the name of the state to attract or confiscate required insurance premia (taxes) from the population whose specific risks are in-principle covered.[13]

Such limits have, in fact, sometimes been exceeded through intergovernmental arrangements.[14] Although modest in scale and scope, for example, agreements are in place among certain national governments to share some of the potential costs of disasters at nuclear power plants. The question before us is whether such arrangements constitute the absolute limit for 'governing' global risks, including new risks that are moving out of the zone of radical uncertainty and into the zone of reasoned calculation.

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where the new money is. By the time statistical probabilities are clear, serious profit is squeezed out of the business. In a competitive environment, the challenge is to make as informed a bet as possible on emerging risks still shrouded in uncertainty. Rough estimates and potentially lucrative contracts are not precluded by a dearth of quantitative data.' Personal interview, Munich, November 25, 2013. The basic point is well explored in Ericson and Doyle, *Uncertain Business*, 2004

[12] See Michael G. Faure and Ton Hartlief, *Insurance and Expanding Systemic Risks*, Paris: OECD, 2003.

[13] Harold James, "The Insuring Instinct," introductory chapter for a volume on Swiss Re, forthcoming.

[14] Charles Goodhart and Dirk Schoenmaker, "Burden Sharing in a Banking Crisis in Europe," *Sveriges Riksbank Economic Review*, No. 2, 2006, pp. 34-57; Dirk Schoenmaker, *Governance of International Banking:The Financial Trilemma*, Oxford: Oxford University Press, 2013.

The Limits of Intergovernmentalism

Restricted intergovernmental arrangements for global risk governance cannot be the end of the story for anyone other than closed-minded ideologues. It takes a fair dose of hubris to believe that human social evolution has somehow reached its end in our own day. On what grounds is it reasonable to assume that human ingenuity exhausted itself in the political construction of the nation-state? On what grounds is it reasonable to assert that although human beings can obviously continue to manufacture global risks, they absolutely cannot design accommodating instruments for managing them. To say the least, such an argument is implausible. There is no good reason to accept it. On the other hand, we must concede that the problem of designing effective tools for global risk governance can be formidable—or, as analysts now call it, 'super wicked'.[15]

At this point, disciplined imagination must be called upon. Some may leap to the logical conclusion. A 'world state' must lie just over the horizon, and a cosmopolitan philosophical tradition stands in readiness to provide justification. If the Kantian dream of a 'parliament of man' was the legacy of 18th century wars, world federalist impulses revived it after both great twentieth-century wars. Indeed, the idea of a global confederation resting on at least a modicum of human solidarity has sprung naturally to mind at every moment of systemic emergency since then.[16] It can be observed, nevertheless, that as soon as most emergencies ends and a semblance of calm returns, the shimmering spirit of solidarity often seems to disappear. But such a skeptical observation does not preclude a more modest quest.

Risks surrounded by uncertainties, by definition, are difficult to assess. The context for decision regarding them will be opaque. Strategic and tactical responses will be unclear. If the threats they suggest are serious, however, passivity can't be the only option. In a complex environment, we might expect to witness experimentation before solid risk calculations can be undertaken.

In the previous work upon which this paper builds, Edgar Grande and I argued that global risks are already the cause of a *substantive and observable transformation of state functions*.[17] The magnitude

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[15] Kelly Levin, Ben Cashore, Steven Bernstein , and Graham Auld, "Overcoming the tragedy of super wicked problems: constraining our future selves to ameliorate global climate change." *Policy Sciences* 45.2 (2012): 123-152.

[16] Alexander Wendt, "Why a World State is Inevitable," *European Journal of International Relations*, vol. 9, 2003, pp. 491-542. Wendt's argument rests on the dynamics of a struggle or political recognition in a culture of anarchy. For an interesting and skeptical dissection of the idea of solidarity that lies beneath other approaches to the same end-point, see Steinar Stjerno, *Solidarity in Europe: The History of an Idea*, Cambridge: Cambridge University Press, 2004.

[17] Edgar Grande and Louis Pauly, eds. *Complex Sovereignty*. Toronto: University of Toronto Press, 2005. As in this paper, the case of the European Union is very much in the background. With regard to the broader issue governance experiments, relevant research on the case is extensive. For an overview, see Thomas Risse and Tanja A. Börzel, "From Europeanization to Diffusion," *West European Politics*, vol. 35, no. 1, 1-19.

and scope of the continuing transformation precludes ignoring it. Pretending it is not underway, however, may well be convenient for policy-makers as well as their constituents. Contrary to much popular commentary, moreover, we also observed that actual states are not all being cut back. Indeed, the scope of public-sector action is *expanding* within and across many contemporary societies. This is occurring, albeit in differentiated ways, despite the common-sense assertion of market liberals as well as keen students of the psychology and sociology of risk that decentralized systems without tight coupling between their various parts best accommodate failure and enhance resilience.[18] As discussed more fully below, a plausible answer to the 'too-big-to-fail' dilemma in finance and other arenas of risk is to break units down to a level where they are not 'too-big'. The fact, however, is that the scale and inter-connectedness of units constitutive of global risks continues to expand. After the crisis of 2008, big banks became bigger even as systemic risk likely migrated to burgeoning nonbanking financial institutions; cross-border and cross-sectoral linkages became more intricate. Similarly, after the Chernobyl and Fukushima disasters, nuclear power was not seriously abandoned in Europe or Japan. To cite one more example, following various public health emergencies emanating from tightly linked global transportation chains, like the SARS epidemic in 2003, those systems became more, not less, integrated in many parts of the world.

We also noted that the continuing expansion and transformation of expectations concerning government action translates into the emergence of a zone of shared political responsibility, whether it is codified and explicitly acknowledged or not. As Grande and Zangl later contended, a key aspect of this evolution deserves emphasis.[19] Global risks shift the motivation for transnational state action *from past and present to the future*. At the center of policy attention across a range of issue-areas is an increasingly undeniable awareness of tomorrow's potential catastrophes. 'Preventive governance' is thus driven by the imperative of avoidance. It needs to be seen as taking action not only after disasters have actually occurred. It is expected to anticipate threats induced by human behaviour, for it will be held by citizens and non-citizens alike as wholly or partially accountable for them.

Albert, Buzan, and Zürn allude to the same phenomenon by applying sociology's differentiation theory to international relations; they see segmented and still-stratified political systems in a condition of deepening tension with feasible and necessary functional responses to practical problems of governance.[20] Foucault highlighted this developing tension in his seminal analysis of 'governmen-

[18] Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable*, New York: Random House, 2007.
[19] Grande and Zangl, "Varieties of Preventive Governance in World Risk Society," unpublished paper.
[20] Mathias Albert, Barry Buzan and Michael Zürn, eds., *Bringing Sociology to International Relations*, Cambridge: Cambridge University Press, 2013.

tality'. The introduction of vaccinations against smallpox in the early 19th century provided an apt reference point. Similarly, the fundamental logic and expansion of Keynesian economic policy in the mid-twentieth century aimed at the mitigation of risks. What is new today is the dawning realization that many preventive policies are futile unless they are pursued jointly by 'sovereign' political authorities.

Preventive governance in a collective sense has to decide pre-emptively how much systemic risk is acceptable to societies no longer separated by clear borders but still potentially exhibiting different risk tolerances. Adding to the difficulty is the reality noted above: those risks are riven by various deep channels of uncertainty, which render the determination of risk tolerances difficult. In still-decentralized political settings, some authorities may be unwilling to accept high preventive costs, while others may be unwilling to accept anything less than strong *precautionary* measures entailing potentially very high opportunity costs. The result may satisfy no one and may actually enhance global risks, but it may also soon shift.[21] In contemporary Europe, for example, we have the recent experience of abundantly precautionary German authorities closing and banning nuclear power plants, while the authorities in some neighbouring lands satisfy themselves with modest measures to reduce the likelihood of future accidents. In these and other cases, such outcomes surely do not establish stable political end-points. Instead, they clarify contradictions and sharpen underlying political conflicts. Their unavoidably transnational logic is dynamic, not static.

Political Conflict and Functional Spillovers

The erosion of functional boundaries around the 'prevention' state confronts modern societies with an expanded problem in controlling political authority. The root of the problem is not the immoderation of citizens, but the crisis-driven immoderation of those with the emerging capacity to act in their name. Existing political controls in advanced societies were constructed within old walls that are becoming ever more ineffective, and defensible new walls cannot easily be built because of functional spillovers. Institutional transcendence and transformation must occur at the same time. Because this is difficult, the transnational sharing of political authority made necessary by the scale and nature of global risks can change the role that law plays. In the middle of the twentieth century, Carl Schmitt anticipated such a change in its least appealing terms. When systemic emergency threatens the very existence of the state itself, law as an instrument of limited political authority can be replaced by law as an unbounded rationale for assertive political decision.

[21] Here we may reach limits to certain kinds of risk analysis. See Cass Sunstein, *Risk and Reason*, Cambridge: Cambridge University Press, 2002; Sunstein, *The Laws of Fear: Beyond the Precautionary Principle*, Cambridge: Cambridge University Press, 2005; Dan M. Kahan, Paul Slovic, Donald Braman, and John Gastil, "Fear and Democracy: A Cultural Evaluation of Sunstein on Risk," *Harvard Law Review*, vol. 116, 2006.

Global risks can evoke a permanent sense of emergency, so a consistent Schmittian argument would today subordinate any normative order to measures necessary to ensure systemic survival. In Agamben's similarly bleak terms, in the 'state of exception' actual state authorities operate in a "no-man's land between public law and political fact, between legal order and life."[22] The 'state of exception' assumes its exemplary form during the tensest moments of crisis, when any constitutional limits to state action recede and generalized fears undercut resistance.

Global risks stretch two dimensions of political action, namely, the identities of key actors and the quality of their instruments. Preventive governance now reaches far beyond the traditional state and its apparatus. It relies on complex institutional settings and a diversity of actors. It also implies a substantial extension and interplay of measures to influence social behaviour. Despite its pathologies, we might expect the *transnational* prevention state to emerge through processes full of conflict, for pre-existing political bargains will likely be undermined. Because such processes will be as difficult to sustain as they will be necessary, we should also expect the locus of final decision-making to become blurred and multi-layered. International organizations, NGOs, multinational firms, and various kind of public and private networks will obfuscate final responsibilities. Decisions may still be made, but they may perhaps now often take the form of non-decisions.[23]

The denial of obvious political responsibility, indeed, may help preserve and even strengthen the capacity of the prevention state. The instrumentality of impersonal markets or informal collaborative forums, boards, and standard-setting associations, may come to be seen as reasonably responsive to a functional logic that renders certain actions necessary. Ideological commitments to 'sovereignty' and 'democratic legitimacy' may remain, but their complexity-in-practice is deepened. One problem may lead to a partial solution, contested but convenient. Its partiality may lead to failure, and the original problem may get worse. Conversely, the partial solution may raise the stakes against a complete reversal. Stumbling forward through political conflicts over responsibilities and outcomes may appear more attractive than any other feasible option. In the end, politicization and underlying legitimation dilemmas may themselves lead to systemic disasters, but they may also provide the spark for political innovation.

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[22] Giorgio Agamben, *State of Exception*, Chicago: University of Chicago Press, 2005. Carl Schmitt, *The Concept of the Political*, Chicago: University of Chicago Press, 2007; *Political Theology*. Chicago: University of Chicago Press, 2006. Also see Christian Kreuder-Sonnen, "Der Globale Ausnahmezustand. Carl Schmitt und die Anti-Terror-Politik des UN Sicherheitsrates," Baden-Baden: Nomos (Internationale Beziehungen 18), 2012.

[23] Steven Lukes, *Power: A Radical View*, London: Macmillan, 1974.

At key moments in a process that may indeed lead to such innovation, a good neofunctionalist might well argue, is the dawning realization of co-responsibility. Jean Monnet once predicted that what we now call the European Union would be built through crises and 'by stealth'.[24] Like David Mitrany, Leon Lindberg, and the early Ernst Haas, scholars labeled him a functionalist, and many came to criticize what they saw as a linear view of historical progress. In the dark shadow cast by Auschwitz, however, the early functionalists could not help but understand the possibility of profound reversals in human achievement. There could be nothing automatic about the construction of political institutions. They may have been ambitious, but they were not naïve. Monnet's wisdom, in particular, rather rested on the calculation of risks to the extent knowledge and memory would allow, on the balancing of prudent preventive measures with reasonable precautions, and on the ability of leaders to steer political conflicts in constructive directions. Uncertainty was the seedbed for such a pragmatic position, as it is for any other kind of faith. In the face of certainty, there is no need for faith.

Is a revived version of Monnet's faith warranted today by the contemplation of risks and uncertainties at the global level? Why would it not be? What would be the alternative? As long as we stay attentive to the possibility of failure, there is no reason to discount entirely the probability that a conflictual process in the shifting borderlands of risk and uncertainty can eventually nurture perceptions of co-responsibility among those with the capacity to act. Shared prior interests in enhancing that capacity may not be determinative, but without them forward movement would be more difficult. Again, in private insurance markets uncertainty does not necessarily lead to stasis. It first stimulates efforts roughly to estimate the odds of catastrophe and the costs of *ex ante* precaution and *ex post* compensation. At the frontier of risk calculation and speculation, it then stimulates the pooling instinct, justified by the law of large numbers. Also at that frontier lies unavoidable political conflict. The 'prevention' state confronting unclear global risks and unavoidably collaborative relationships may move smoothly toward greater transnational burden sharing, although we cannot preclude the possibility that it may not. The hope would be that new political struggles eventually culminate in the construction of new global decision-making structures. The retrospective analytical question would then become, did there exist a less traumatic alternative path toward effective and legitimate global-risk governance.[25]

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[24] Jean Monnet, *Memoirs*, New York: Doubleday, 1978; François Duchêne, *Jean Monnet: First Statesman of Interdependence*, New York: W.W. Norton, 1980.

[25] At the root of long and continuing debate on the post-war integration of Europe lies the same question. That technocratic 'faits accomplis' designed to get around nationalist blockages would create 'democratic deficits' is perhaps less surprising than the 'integration fatigue' widely exhibited by analysts and observers. For a skeptical view, see Giandomenico Majone, *The European Union's Democratic and Other Deficits: Back to the First Principles*, Salzburg Papers on European Integration 01-10, SCEUS Salzburg Centre of European Union Studies/Jean Monnet Centre of Excellence, April 2010; and *Dilemmas of European Integration: The Ambiguities and Pitfalls of Integration by Stealth*. Oxford: Oxford University Press, 2005.

Such a question suggests even at this point in time a realistic approach to analyzing the capacity to govern global risks, an approach that distinguishes among the politics of risk assessment, of risk reduction and crisis prevention, and of compensation and resolution. Empirical observation promises to bring key differences into focus. In what follows, I draw illustrative material from the contemporary political economy of financial markets.

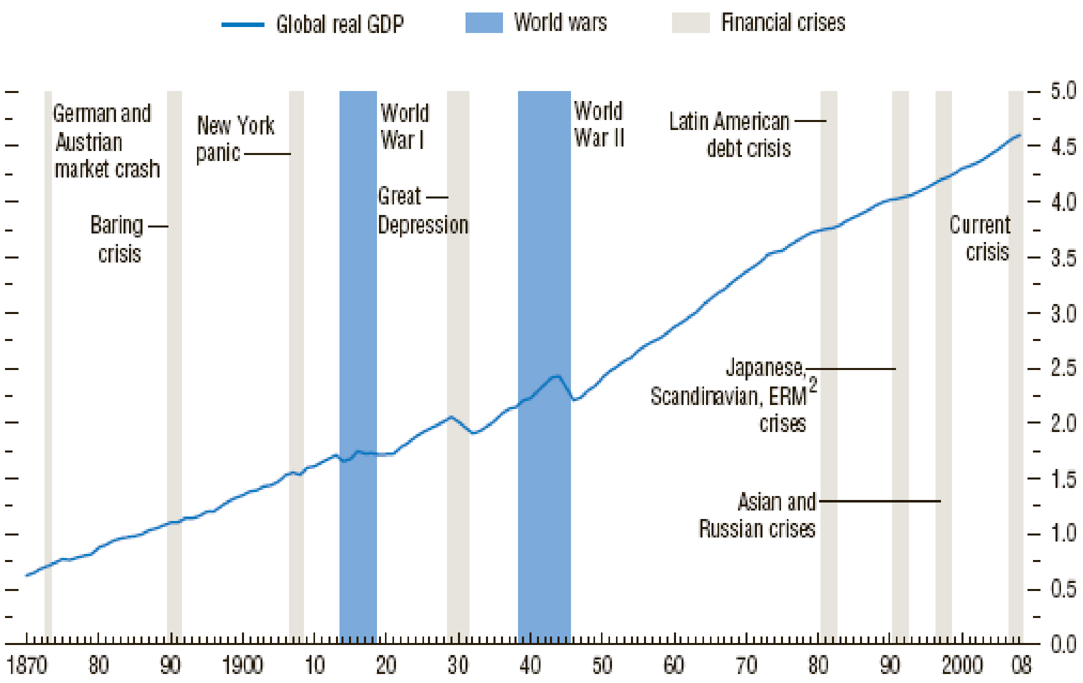
III. Global Financial Risks

The historical experience of social and political integration changed when sovereign nation-states in Europe began to claim "exclusive authority over a given territory and at the same time this territory was constructed as coterminous with that authority, in principle ensuring a similar dynamic in other nation-states."[26] In Europe and eventually elsewhere the authority of the state was asserted over markets and market economies that had arguably established themselves long before. Market behavior thereafter could not easily be conceived as spontaneously derived from human nature. In a broader sense, older and looser economic linkages gave way to formal and informal arrangements shaped by nation-states, while relationships among those nation-states were ever more obviously mediated by financial markets. In this context and over time, national security, economic growth, and financial stability came to be associated more closely. At the risk of oversimplifying much, we can at least observe that since the dawn of modern capitalism the most traumatic international conflicts have coincided with periods of financial crisis and systemic economic decline. (See Figure 1 below.)

Figure 1

[26] Saskia Sassen, *Territory, Authority, Rights* (Princeton: Princeton University Press, 2006), p. 6; also Stephen Streeter, John Weaver, and William Coleman, eds., *Empires and Autonomy: Moments in the History of Globalization*, edited by, Vancouver: University of British Columbia Press, 2009.

Global Real GDP[1]
(Log scale)



Sources: Angus Maddison, Historical Statistics Database; Bordo (2006); Conference Board, Total Economy Database; Reinhart and Rogoff (2008a and 2008b); and IMF staff calculations.

[1]For advanced economies, data start in 1870, except for Greece and Ireland data, which start in 1921. For emerging and developing economies, data start in 1950, except for Ecuador and Paraguay, which start in 1939; Poland and Romania in 1929; Bulgaria, Hungary, and Turkey in 1924; Costa Rica, Czechoslovakia, El Salvador, Guatemala, Honduras, and Yugoslavia in 1920; Malaysia, Korea, and Taiwan Province of China in 1912; Philippines in 1902; Argentina, Colombia, Mexico, Peru, and Venezuela in 1900; India in 1884; and Brazil, Chile, Indonesia, Sri Lanka, and Uruguay in 1870.

[2]ERM = European exchange rate mechanism.

From: IMF, *World Economic Outlook*, Washington: IMF, October 2009, p. 129.

After the end of World War II, supraterritorial impulses confronted now-traditional rights and obligations of state citizenship. The strengthening of those impulses since then has supported the idea that a companion normative system is developing alongside the observable rule of nation-states. Marx's analysis of the inexorability and ultimate fragility of capitalist growth certainly opened one prominent pathway for thinking about such a development. Today, other traditions of thought lead to the conceptual linkage of scientific and legal innovations with positive as well as negative political consequences. Few scholars doubt, however, that the contemporary experiment in global interconnectedness would have been possible without the sophisticated economic and technological capabilities nurtured over the past century by certain key states and then promoted by them inside the territories of other states. Sometimes by accident and sometimes by design, sometimes directly and sometimes indirectly, leading states--and the United States in particular-- built the material and ideological infrastructure for supraterritorial connectivity.[27] Globalizing financial markets illustrate the process.

The connection between collapse of the Bretton Woods exchange-rate system in 1973 and a broadening movement toward more open national financial markets was not coincidental.[28] The transfers of capital necessary to facilitate international economic adjustment and development could have occurred through official channels. At each critical juncture between 1945 and 1973, however, opening and expanding private financial markets marked the path of least policy resistance. Thereafter, policy experiments with deregulation and liberalization at the national level went hand in hand with official efforts at the international level simultaneously to encourage competition <u>and</u> prudent risk-taking by banks and other financial intermediaries. Acquiescing in market-opening and acceding to competitive impulses are relatively easy policy tasks. Fostering prudence is not. Financial panics recurred with some regularity after the 1970s. The same thing happened in the pre-1914 era of financial openness, but technological developments and the realities of market scale and scope since then meant that periodic emergencies now spread more rapidly across both functional and geographic borders. Integrating markets exhibited behavior akin to that of a manic depressive. Periods of ecstatic euphoria were almost routinely followed by periods of black despair. In contrast to the pre-1914 era, however, governments now just as routinely intervened to manage market emergencies. The political consequences were profound and no longer easily kept within national limits.

In the late 1990s, panic spread from stock to bond to banking markets in East Asia, and then to their counterparts in Russia, Latin America, and eventually to Wall Street. Ten years later, and as discussed more fully below, a new systemic crisis originated in the United States. Looming over economic policy-makers there and elsewhere during both emergencies was the specter of the terrible decade spanning the US stock market collapse in 1929 and the opening of the Second World War in 1939, when economic depression brought widespread unemployment and political extremism in its wake.

Notwithstanding the movement toward freer international capital movements, the mutual awareness of *systemic risk* prompted governments throughout the world to reinforce their vital national payments systems, not least by extending implicit or explicit guarantees to banks at the core of those systems. It also focused attention on the linkages connecting those systems to one another.

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[27] Saskia Sassen, *Deciphering the Global*, London: Routledge, 2007.

[28] For extended treatments, see my "The Political Economy of Global Financial Crises," in *Global Political Economy*, Fourth Edition, edited by John Ravenhill, Oxford: Oxford University Press, 2014, chapter 8; and "Managing Financial Emergencies in an Integrating World," *Globalizations*, vol. 6, no. 3, September 2009, pp. 353–364.

Alan Greenspan, a great champion of market liberty before and after his time as chairman of the US Federal Reserve, conceded his "state of shocked disbelief" that a system that for forty years had been "working exceptionally well" came very close to collapsing in 2008.[29] In fact, his disbelief rested on the human frailty of disaster myopia, a frailty deeply rooted in modern financial markets.[30] Without confidence in the future, even if ill-informed, it would make little sense to save, invest, or speculate. In the end, Greenspan's disbelief only served to revive, presumably for a short time, a long line of thinking about financial risks inspired by the pioneering insights of scholars like Frank Knight, John Maynard Keynes, Karl Polanyi, Hyman Minsky, Charles Kindleberger, and Susan Strange.[31] Crises are to be expected in financial markets, not least because of features hard-wired into the behavior of human beings and their social groupings. In 1841, the forerunner of behavioral economics, Charles Mackay, summed up the situation in a treatise entitled *Extraordinary popular delusions and the madness of crowds*. But nowhere is it written in stone that consequent crises have to be frequent and capable of bringing down larger systems of social and political order.

Contemporary financial markets rest on legal and therefore political foundations. Market actors need clear operating rules. Property rights have to be established and adjudicated when disputes arise. Procedures have to be in place to handle inevitable failures. The more dense the webs of financial interconnectedness become, the greater is the need to limit the chance that specific debt defaults cascade and engulf otherwise healthy borrowers and lenders. As Walter Bagehot made plain as early as 1873, some agency has to be entrusted with the responsibility and given the ability to act as lender-of-last-resort during liquidity crises.[32] In light of the risk that the very existence of a back-up insurance facility could tempt potential beneficiaries to act imprudently ('moral hazard'), last-resort lending had to be complemented by regulatory disincentives to rely upon it. To deal with extreme instability, when liquidity crises are difficult to differentiate from solvency crises and systemic collapse is plausibly threatened, that lender-of-last-resort also has to be backed by an investor-of-last-resort, an investor with unlimited access to the currency required to absorb losses and decisively stop financial contagion from spreading. Both functions today implicate governments with access to central bank printing presses and national treasuries.

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[29] Alan Greenspan, A. Testimony before the House of Representatives, Committee on Oversight and Government Reform, Bloomberg News (on-line), October 23, 2008. Also see his *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting*, New York: Penguin, 2013.

[30] Jack Guttentag, *Disaster Myopia in International Banking*, Essays in International Economics, Princeton: Princeton University International Economics, 1986. The basic insight is an old one. In his 1874 essay "Untimely Meditations: The Use and Abuse of History for Life," Friedrich Nietzche was surely not the first to notice the evolutionary impulse provided by the human propensity for selective forgetting.

[31] Frank Knight, *Risk, Uncertainty and Profit*, New York: Augustus M. Kelley, 1921/1964; Karl Polanyi, *The Great Transformation*, New York: Farrar & Rinehart, 1944; Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, New York: John Wiley & Sons, 1978; Hyman Minsky, *Stabilizing an Unstable Economy*, New Haven: Yale University Press, 1986; Susan Strange, *Mad Money*, Ann Arbor: University of Michigan Press, 1998; Robert Skidelsky, *Keynes: The Return of the Master*, New York: Public Affairs, 2009.

[32] Walter Bagehot, *Lombard Street: A Description of the Money Market*, New York: Scribner, Armstrong, and Co., 1873.

The members of the contemporary eurozone are often viewed as exceptional in this regard. It is more accurate, however, to see them as mid-way through an experiment that will likely lead either to the regional integration of monetary, fiscal, and regulatory authorities or to the dis-integration of the regional economy as national authorities facing emergencies recover the full range of their prerogatives. A recent study focused on stability in the member-states of the eurozone puts the essential matter succinctly:

> The ongoing process of European integration has led to European member states' economies becoming more closely interwoven. As a result, decisions or failure to take decisions on economic policy by individual countries no longer simply have an impact on their domestic economies but can also have a significant effect on growth and economic stability in every country in the eurozone. Today eurozone countries all share a common fate.[33]

In Europe and beyond, however, economic interdependence is only one part of the story. Again, after 1945 and especially after 1947 when the Cold War commenced, it was the desire for economic growth that sparked processes of policy innovation that would eventually re-open and deepen financial markets, even at the risk of some 'instability'. Indeed, the second step was to try to limit that risk by assigning the bulk of regulatory and supervisory responsibilities to central banks and other official agencies, which would be expected to collaborate but only to the extent necessary to preserve their domestic orders. Most advanced states initiated some kind of deposit insurance scheme and central liquidity mechanism to ameliorate the risk of domestic bank runs, but most also tried to leave as much scope as domestic circumstances would allow for prudent self-discipline by market actors themselves. They have frequently been disappointed.[34]

Across the developing world, a challenge repeatedly confronted in more recent decades has been to create similar facilities. When it could not be met, and especially when financial distress threatened global order, the supplementary resources and conditional lending practices of the International Monetary Fund were now available. Partly because the Fund's underlying authority was of a treaty-limited and delegated nature, however, myriad economic and political controversies were always associated with its evolving crisis-management role.

[33] Matthias Schaefer et al., *Perspectives for a Common Stability Culture in Europe*, Berlin: Konrad Adenauer Stiftung, January 2013, p. 1.

[34] For analysis of the reasons why, see Walter Mattli and Ngaire Woods, ed., *The Politics of Global Regulation*, Princeton: Princeton University Press, 2009; and Tim Büthe and Walter Mattli, *The New Global Rulers: the Privatization of Regulation in the World Economy*, Princeton: Princeton University Press, 2011.

As financial markets became more integrated across the political boundaries of both developed and developing countries, a basic governance deficiency became ever more apparent. Intergovernmental agencies can help recognize and measure related risks. Organizations like the IMF can also help reduce the probability of disasters through the identification of the spillover effects of national policies, the provision of technical advice, and the encouragement of prudence among their members.[35] But the instruments at their disposal are slow and unwieldy. They can sometimes manage localized crises but are not well-suited for systemic emergencies, especially those involving advanced economies. They can also evince systematic biases, sometimes shaped by the interests of principal stakeholders or the ideational leanings of staff.[36] They have no deficit-spending capacity and no currency printing presses. They are ill-equipped to handle the often-fraught domestic politics surrounding the distribution and redistribution of the crisis-driven costs of adjustment. In short, they underline the absence of a clearly constituted global polity capable in a systemic emergency of sustaining last-resort lending and investing instruments analogous to those established at the national level. The classic response of IOs and their architects to the resulting conundrum has been to extol the virtues of voluntary and mutually self-interested inter-state cooperation. They too have frequently been disappointed.

Mutual interests remain, but voluntarism in the face of globalizing financial markets has begun to seem quaint. To understand where the experiment in financial integration has now led us, it is useful to separate out the politics of risk recognition, crisis prevention, and emergency resolution.

Recognizing and Assessing Global Financial Risks

Well into the 1980s, the main arenas within which national regulators sought to cooperate in their risk-recognition and measurement activities were easy to identify. After the fallout from the 1974 failure of Germany's Herstatt Bank spread globally through foreign exchange markets, regulatory interaction became multilateralized through a central bankers' club hosted by the Bank for International Settlements (BIS). Originally established to manage reparations payments after the First

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[35] Current events provide an excellent example. On the effects in emerging-market and developing countries of the crisis-management and economic stimulus policies of advanced-economy countries, see Ngaire Woods and Max Watson, eds., "High-Level Roundtable on Finance: How are emerging and developing countries affected by monetary and regulatory spillovers from advanced economies?" *Conference Report*, Blavatnik School, Global Economic Governance Program, and Political Economy of Financial Markets Program, Oxford University, 2014; Max Watson and Russell Kincaid, "International policy coordination: Macroprudential policies and the 'new normal'," *Political Economy of Financial Markets Papers*, Oxford University, March 2014.

[36] See, inter alia, Stephen C. Nelson, "Playing Favorites: How Shared Beliefs Shape the IMF's Lending Decisions," *International Organization*, vol. 68, 2014, pp 297-328; Randall Stone, *Controlling Institutions: International Organizations and the Global Economy*, New York: Cambridge University Press, 2011; Jeffrey Chwieroth, *Capital Ideas: The IMF and the Rise of Financial Liberalization*, Princeton, NJ: Princeton University Press, 2010; Mark Copelovitch, *The International Monetary Fund in the Global Economy*, New York: Cambridge University Press, 2010.

World War, the BIS survived attempts to close it down after 1945. Thirty years later, after it had developed a profitable business managing central-bank reserves, it proved a convenient venue for monetary and financial meetings and a source of staff support. The Basel Committee on Banking Supervision (BCBS) was the first of the clubs to benefit from its existence.[37]

The focus of the BCBS is at the micro-level, and specifically on large banks operating across national borders. In 1999, leading governments established the Financial Stability Forum (FSF) to concentrate on the macroeconomic implications of the expanding operations of those financial institutions. As we shall see, 'macroprudential policies' came to the forefront when the FSF became the Financial Stability Board ten years later. Other bodies now convened at the BIS include, inter alia, the International Association of Deposit Insurers, and the International Association of Insurance Supervisors. Together, the often-overlapping activities of these clubs have come to be called the 'Basel Process'.

Banking crises initially led the BCBS to propose a concordat to clarify the respective responsibilities of the home and host country supervisors of cross-border banks, and then to experiment with protocols for minimum standards for capital reserves expected to absorb losses and reduce the likelihood that national monetary and fiscal resources would be called upon during periods of instability (Basel I). It also commenced work with other national and regional bodies to bolster the effectiveness of prudential supervision within and beyond the banking sector narrowly defined. In 2006, the most extensive and detailed effort to ensure capital adequacy came in an accord commonly dubbed Basel II. Under its terms, international lenders were encouraged to bring sophisticated and self-disciplined risk-management techniques into calculations of capital adequacy. The politics of policy-making through technocratic clubs here reached a limit, not least because underlying risk-cultures across major states and regions remained distinctive.

The fact that the implementation of Basel II left much discretion for national supervisors was only one source of future trouble. The accord soon appeared to enhance the competitive advantages and leverage of large money-center banks. Astute observers pointed out that its impact was 'procyclical,' that is, it encouraged banks excessively to restrict lending during recessions and imprudently to expand lending during booms. They were right.

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[37] Charles Goodhart, *The Basel Committee on Banking Supervision*, Cambridge: Cambridge University Press, 2011; Ethan Kapstein, *Governing the Global Economy: International Finance and the State*, Cambridge, MA: Harvard University Press, 1998.

Preventing Future Crises

After each banking crisis since 1973, better technical policy co-ordination was seen as necessary to promote the deepening integration of financial markets and to extend that experiment safely beyond the core of the system. Aside from Basel I and Basel II, one tangible consequence was the development of payment-settlement systems that promised to limit cascading defaults (real-time gross settlement systems and continuous linked settlement platforms). More broadly, if agreements on standards and collaborative regulatory networks failed, two other policy instruments remained in the arsenals of states seeking to prevent financial crises from spilling over into their markets: capital controls and expanding foreign exchange reserves.

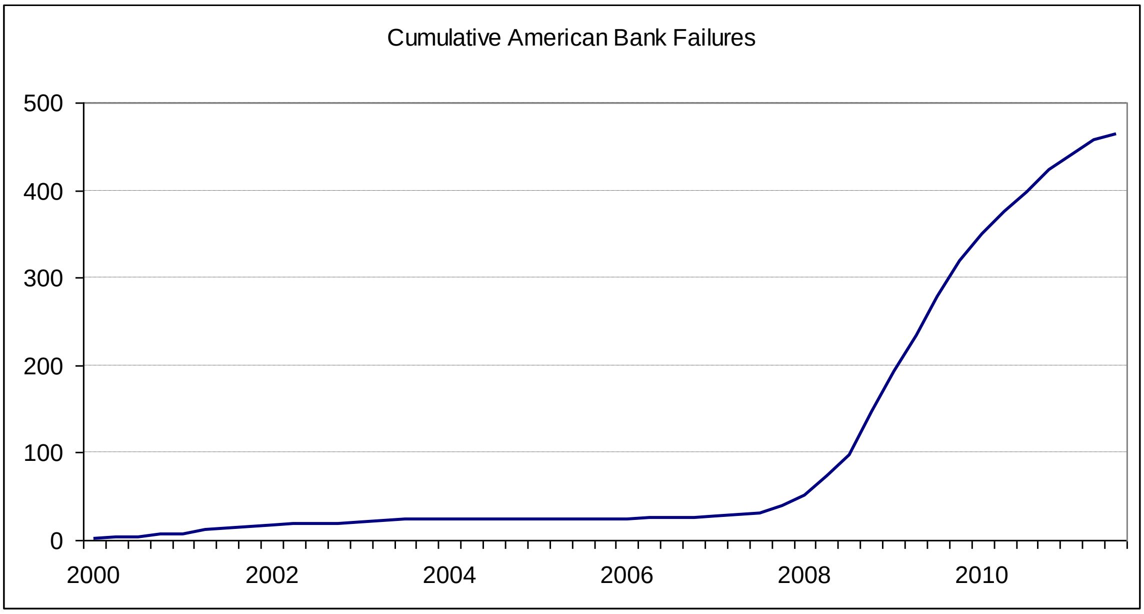
In the end, the experiment in financial integration depends on compatible fiscal and monetary policies at the core of the world economy. In the absence of some kind of external incentive to encouraging such outcomes after 1973, states could only agree to open their financial markets and to promote 'a stable system of exchange rates' facilitated by the 'firm surveillance' of the International Monetary Fund. Some hoped that those markets themselves would force constructive adjustments in underlying macroeconomic policies, but their most common effect was to accommodate them except in extreme circumstances.

The main symptom of consequent problems took the form of rapidly expanding imbalances in the current accounts of leading countries. By the turn of the twenty-first century, it was clear that the United States was importing too much, saving too little, and depending for its financing needs on vast inflows of capital from China, Japan, Germany, and many middle-income and developing countries. For a time, the situation looked like a happy one for all concerned, not least for the cross-border financial institutions handling the requisite, if ironic, capital flows from relatively poor countries to relatively rich countries. Instead of encouraging macroeconomic adjustments, expanding capital markets permitted imbalances to grow. Loose monetary policies, lax regulation, remarkably high leverage in key financial intermediaries, illusory financial innovations, a broadly underappreciated turn in the business cycle, and the reliance of leading states on particular sectors, like housing, to sustain national prosperity—are now all commonly blamed for what happened next.[38] Real-estate related bank failures were not new in American history, but after 2007 staggering numbers occurred (Figure 2 below). In their wake, the capacity of existing multilateral arrangements to preempt contagion across the markets to which those banks were now directly or indi-

[38] Eric Helleiner, Stefano Pagliari and Hubert Zimmerman, eds., *Global Finance in Crisis*, London: Routledge, 2009; Andrew Ross Sorkin, *Too Big to Fail*, New York: Viking, 2009; Joseph E. Stiglitz, *Making Globalization Work*, New York: W. W. Norton, 2009; Herman Schwartz, *Subprime Nation: American Power, Global Capital, and the Housing Bubble*, Cornell: Cornell University Press, 2009.

rectly connected proved inadequate. The politics of tacit intergovernmental understandings, together with reliance on inadequately equipped IOs, failed to preempt a systemic financial emergency that threatened the second Great Depression.

Figure 2



Source: US Federal Deposit Insurance Corporation, "Failed Bank List".
(http://www.fdic.gov/bank/individual/failed/banklist.html**)**

The attention of policy-makers now turned away from crisis prevention to crisis management. Indicative of a rapidly broadening sense that more countries needed to be involved in both efforts was an expansion in the membership of the BCBS and other BIS-hosted clubs. By March 2009, the number of countries around the table grew from 13 to 27, with the inclusion of advanced developing countries from the G20. At the same time, the FSF became the FSB, and its staff was mandated to accelerate an ambitious work program on the constituent elements of more stable and resilient financial markets, including but not limited to capital buffers, minimum liquidity ratios, and maximum leverage requirements for banks and other financial institutions deemed to be 'systemically significant'. Although this episode in preventive institution-building appeared quite consistent with earlier technocratic efforts centered on central banks and supervisory institutions, it actually masked the re-assertion of finance ministries in the face of a systemic crisis.

Managing Emergencies

Governments around the world intervened heavily and directly in global markets in the fall of 2008 and for many months afterwards. The United States in particular lent and invested monetary and fiscal resources lavishly. The beneficiaries included most of its own large financial institutions and many foreign institutions operating within and across its borders.
In the immediate aftermath of a US decision to let the Lehman Brothers investment bank fail outright, banks around the world confronted a drastic shortage of liquidity. In loosely coordinated operations, central banks pumped billions of dollars into money markets. Simultaneously, leading governments moved to ban the speculative short-selling of financial stocks. During the first days of October 2008, President Bush signed the $700 billion Emergency Economic Stabilization Act into law; $250 billion would be taken from the resulting fund and used to purchase troubled assets from American and foreign banks. Fearing economic collapse, central banks around the world simultaneously slashed short-term interest rates and pumped out cash. At this point, it was reasonable to ask whether the problem for many banks was one of liquidity, the traditional concern of central banks, or solvency. Consistent with signals coming out of the US Treasury, the Fed also provided massive swap facilities to many foreign central banks, which were themselves under pressure to lend dollars as well as local currency to support the stressed operations of their own banks at home.

In December, President Bush announced plans to provide General Motors and Chrysler with $17.4 billion. Two months later, the US Treasury announced a Financial Stability Plan involving purchases of convertible preferred stock in eligible banks and a Public-Private Investment Fund to acquire more troubled assets from financial institutions. These measures were complemented by the continuing expansion of the Fed's liquidity operations. One week later, a new $787 billion fiscal stimulus plan, the American Recovery and Reinvestment Act of 2009, was signed into law. On March 1, having already tried to shore up AIG, an insurance company that found itself at the center of an imploding global market for financial derivatives, the US Treasury provided an additional $30 billion in capital after the company announced a $61.7 billion loss, the largest in US corporate history. AIG was then essentially nationalized, and subsequent decisions were made in effect to use US taxpayer dollars to pay AIG's obligations in full to major counterparties—dollar for dollar, without a haircut. Major foreign financial institutions benefited directly.[39]

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[39] On the Canadian experience, see Louis W. Pauly, "Canadian Autonomy and Systemic Financial Risk after the Crisis of 2008," chapter in *Crisis and Reform: Canada and the International Financial System; Canada Among Nations*, vol. 20, edited by Rohinton Medhora and Dane Rowlands, Waterloo, ON: Canadian Institute for Governance Innovation, 2014, pp. 161-180. On the experience of European and other banks, see Lawrence Broz, "The Federal Reserve as Global

The following table provides just one insight into the implications of the interventions designed to help the world's leading banks recover from their crisis-driven losses. It provides estimated earnings generated by selected banks drawing on Fed liquidity facilities, the spread between what they paid for their funding and what they likely earned from onward lending.

Table 1

Estimated Earnings Attributable to Federal Reserve Operations
(August 1, 2007-April 30, 2010; US$ millions)

Beneficiary	Earnings
Citibank	1,800
Bank of America	1,500
Royal Bank of Scotland	1,200
Wells Fargo	878
Barclays	641
JP Morgan	458
Dexia	350
Credit Suisse	285
Deutsche Bank	253
Unicredit	221
BNP Paribas	175
Societe Generale	170
Toronto-Dominion Bank	154
Fortis Bank	106
Sumitomo Mitsui Bank	106
Goldman Sachs	100
Standard Chartered Bank	56
Canadian Imperial Bank of Commerce	20

Source: Federal Reserve data, compiled by *Bloomberg Magazine*, www.bloomberg.com, November 28, 2011, accessed April 11, 2014.

Lender of Last Resort, 2007-2010," paper presented at the annual meeting of the International Political Economy Society, University of Virginia, 2012.

In circumstances where illiquidity and insolvency were not easy to differentiate, 190 firms benefited from Fed liquidity facilities between 2007 through 2010. The total earnings attributable to them topped US$13 billion, a figure that must be set against estimates of US$21.6 billion in their total losses during the crisis period. There is nothing unique about this effect, for that is what is often meant by recapitalizing institutions at the core of vital payments systems. This one slice of data, however, is illustrative of the impact of a massive set of programs put in place by the US central bank and Treasury to inject liquidity and capital into intricately linked markets around the world. Other Federal Reserve actions at the time are worth a deeper look.

Currency swaps between central banks are hardly novel. Typically done at fixed exchange rates for limited terms at modest interest rates, they help central banks meet foreign-currency demand in their local markets. The originating central bank bears no credit risk associated with direct exposure to ultimate beneficiaries and no foreign exchange risk. It does, however, take on the risk that the counterparty central bank may default when it comes time to reverse the swap (sovereign risk). The recipient central bank, in turn, can offer foreign-currency loans to local financial institutions (including the subsidiaries or branches of foreign institutions) under its purview, and by doing so it assumes credit risk. During the crisis of 2008, and especially after the panic caused by the failure of Lehman Brothers, US dollar liquidity in American and foreign markets dried up. Similarly, demand for other reserve currencies, especially the euro and to a lesser extent the Swiss franc and the Japanese yen, spiked. The classic solution was for the producers of reserve currencies to open up the tap inside their home markets and to engage in swaps with their primary foreign counterparts. The novelty during this crisis came in the unprecedented scale and speed of such operations, and later in the rendering of some new swap facilities permanent.

In essence, mutually self-interested and informally coordinated actions by key-currency central banks activated and significantly deepened three swap networks centered on the Fed and the dollar, the ECB and euro, and the Swiss National Bank and the Swiss franc. Additionally, the kinds of regional swaps put in place during and after previous crises in Asia and Latin America were again available. From 2007 onwards, nearly half of all potential foreign-currency demand from local financial institutions around the world was for US dollars, including demand originating from US bank subsidiaries and branches whose parent banks had pulled liquidity home as US markets were contracting. Swap facilities from the Fed, therefore, played a crucial role, directly by keeping US dollar markets liquid and indirectly in reassuring market participants that funding risks would remain limited. The fourteen countries listed in the table below negotiated swap lines with the Fed. All but four eventually drew on them, but each one benefited from the market-calming influence of their very existence.

Table 2

Drawings on US Dollar Swap Facilities Provided by the Federal Reserve

(US $ millions, end of quarters)

End of	2007Q4	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2	2009Q3
Canada								
ECB	20,000	15,000	50,000	174,742	291,352	165,717	59,899	43,662
Switzerland	4,000	6,000	12,000	28,900	25,175	7,318	369	0
Japan				29,622	122,716	61,025	17,923	1,530
UK				39,999	33,080	14,963	2,503	13
Denmark				5,000	15,000	5,270	3,930	580
Australia				10,000	22,830	9,575	240	0
Sweden					25,000	23,000	11,500	2,700
Norway					8,225	7,050	5,000	1,000
N Zealand								
Korea					10,350	16,000	10,000	4,050
Brazil								
Mexico							3,221	3,221
Singapore								
TOTAL	24,000	21,000	62,000	288,263	553,728	309,918	114,585	56,576

Source: Federal Reserve Bank of New York data, William A. Allen and Richhild Moessner, "Central bank co-operation and international liquidity in the financial crisis of 2008-9," *BIS Working Paper*, No. 310, Bank for International Settlements, May 2010, p. 45.

The big jump in swap line usage obviously occurred in the fourth quarter of 2008 after the Lehman Brothers default. Of even more note was the unprecedented decision by the Fed at that point to offer—without any upper limit--support for longer-term and forward US-dollar liquidity provision by the central banks of Europe, the United Kingdom, Japan, and Switzerland. These lines expired early in 2010, but similar facilities for Canada, Europe, the UK, Japan, and Switzerland were created in the spring in the wake of an emergency in the eurozone.[40] In October 2013, the Fed, the ECB, and the central banks of Canada, the UK, Japan, and Switzerland agreed to convert limited facilities to standing lines able to be drawn upon when needed.

Again, it is important to underline that the central banks were not alone in their emergency management activities. The US governmental initiatives noted above were only among the most

[40] William A. Allen and Richhild Moessner, "Central bank co-operation and international liquidity in the financial crisis of 2008-9," *BIS Working Paper*, No. 310, Bank for International Settlements, May 2010, p. 29-30.

prominent.[41] Between September 2008 and June 2009, advanced-economy governments around the world announced some 34 systemic or institution-specific programs involving bank recapitalization, debt guarantees, asset purchases and guarantees, and increases in deposit-insurance limits.[42] The politics of emergency management at the domestic level essentially permitted informally coordinated assertive action by national authorities at the core of the system.

From Crisis Management to Compensation and Resolution

The emergency responses of the United States and other leading countries may have steered the global economy away from depression a few years ago, but they also pointed to the special political and economic risks now undeniable in the post-1973 experiment in systemic financial integration. In 2008, it became obvious once again that missing at the global level when systemically vital firms and even countries cannot service their debts are unquestioned instruments for orderly resolution. Absent are internationally agreed liquidation procedures and an unambiguously neutral arbiter to replace managers and supervise the shared adjustment of corporate and national balance sheets. This is, of course, no accident. In the conceptual extreme, the sovereignty of a state implies the right to default on debts or to permit such defaults by entities it licenses. As a classic realist might argue, the ability in practice to claim such a right is in the final analysis a function of the raw power a state has in its possession to enforce such decisions. We were again reminded in 2008, however, that in the real world of globalizing finance the actual autonomy of participating states is fundamentally compromised by functional spillovers. In such circumstances, uncertainties generated by the absence of final resolution mechanisms can credibly threaten to bring down the whole system. The massive provision of liquidity can calm the situation, but it can also compound the resolution problem.

The architects of the post-1945 system considered economic instability to be the precursor of war. At Bretton Woods, therefore, they took the first steps in designing mechanisms that would limit the extent to which sovereign participants in the system would find themselves pushed to default on their debts. Time and again, from 1945 until the present moment, the main creditor states and the private financial institutions they license and regulate found themselves designing and redesigning substitutes for gunboat diplomacy, namely programmes that provide certain debtor states with the equivalent of last-resort lending facilities or of debt-restructuring services loosely analogous to those found in domestic bankruptcy courts.

[41] Timothy Geithner, former US Treasury Secretary, sets out clearly and in context the massive fiscal and monetary measures of the United States at the point of emergency. See *Stress Test: Reflections on Financial Crises*, New York: Crown, 2014.

[42] Fabio Panetta et al., "An assessment of financial sector rescue programmes," *BIS Papers*, no. 48, Bank for International Settlements, 2009, p. 8.

In the early post-war decades, the main economic imbalances capable of derailing the system as a whole occurred in industrial countries. They typically manifested themselves as currency crises (when governments sought to defend the par value of their currencies while running substantial trade deficits), so it was no coincidence that the IMF was often enlisted afterwards to bless new currency pegs or unorthodox financial arrangements. During the 1980s and 1990s, the main crises capable of destabilizing the system began in emerging markets, and more often than not conditional IMF assistance could be called upon. For certain developing countries, and mainly when intermediaries in advanced countries were threatened, sovereign debt rescheduling and restructuring became more commonplace. International banks as well as official agencies providing export credits also organized themselves into negotiating groups (the so-called London Club and Paris Club, respectively) to manage similar arrangements and, in effect, to write down the present value of excessive indebtedness. For particular intermediaries caught up in those crises, the BCBS would continue to affirm that home states were primarily responsible for their regulation and, if need be, the final resolution of their bad-debt problems.

In 2008 the machinery for systemic emergency management came out of the shadows. What fundamentally overcame the crisis, as noted above, were dramatic and self-interested policy decisions taken by the United States.[43] Supportive actions coming from other G20 countries, including especially China, were also directly in line with their own interests. Moreover, the networks of cross-national communication that seemed to fail at the moment Lehman Brothers collapsed, suddenly kicked into high gear in the effort to stem the subsequent market panic. In the end, crisis management depended on unprecedented fiscal and monetary actions by the United States and *ad hoc* coordination with other leading states. This was followed by a return to the forefront of transnational policy-making the agenda of preventing the next crisis. Promising moves were soon taken, for example, to provide more comprehensive supervision of cross-border financial institutions through 'colleges' involving home and host-country supervisors. Nevertheless, the question of how to resolve the underlying causes of such emergencies, now likely exacerbated by new debts incurred and risks transferred from the private to the public sector, remains.

The continuing absence of formal supranational resolution mechanisms stands in contrast to the progress made in recent years on the collaborative measurement of financial risks and, to a lesser but not insignificant extent, on the design of instruments to forestall future crises. Two

[43] Dan Drezner, *The System Worked: How the World Stopped Another Great Depression*, Oxford: Oxford University Press, 2014.

reasons are clear. First, resolving over-extended sovereigns or large cross-border private institutions involves compensation and the potentially extensive sharing of losses. Distributing gains is not always easy; distributing losses—with finality—is profoundly difficult. That it implies intense political conflict should come as no surprise. Second, moral hazard undermines any push for policy clarity. Decisions taken since 1945 have left us with a system comprised of increasingly open national markets interacting ever more intensively with one another through mechanisms not fully controlled by any one nation-state, even the United States. Traditional security dilemmas are bound up with market-economy macropolitics. Functional spillovers exist simultaneously with still-significant degrees of systemic segmentation and stratification. If the modalities of resolving the problems of sovereign or cross-border financial institutions were completely clear *ex ante*, which would imply fiscal backstops, a supranational supervisor would have to be in place to ensure that the managers of those institutions did not act imprudently. One 'solution' to this conundrum is as obvious as it is compelling to both libertarians and communitarians. Go back. Break up the big cross-border intermediaries. Bring them back to a scale and scope that can be resolved by well-constituted national authorities. Compelling. Elegant. There is only one problem. Despite the dimensions of the 2008 crisis, and despite some limited moves toward ring-fencing by host countries demanding that foreign firms hold more capital locally, still-globalizing markets are moving in the opposite direction. Revived competitive pressures to allow national champions to operate globally, the local costs of actually limiting capital inflows and outflows, the reluctance to move back to a pegged exchange-rate system—all impel us back to the *status quo* before 2007. And then the disaster myopia, the myriad acts of forgetting that together translate into market confidence, kicks in.

The true dimensions of the dilemma are partly obscured by the arenas within which underlying political conflicts are played out. The technocratic politics of risk measurement and assessment appear more tractable and fluid right after crisis conditions subside, but it also continues to be marked by differing risk cultures, accounting standards, and supervisory practices. When it comes to improving feasible prevention strategies, moreover, hopes are raised immediately after emergencies pass, even as the politics of loss-avoidance gives way gives way to the more difficult politics of sharing competitive gains. At this point, the politics of designing and implementing final resolution instruments becomes even more contentious. The sustainability of global financial markets then hinges on whether the experience and prospects of repeated systemic crises can incrementally emanate in the broadening sense of solidarity and co-responsibility. Successfully building on the collaborative risk assessment and crisis prevention capacities signified by the organizations, clubs, and colleges that have developed significantly of late would seem to depend on it. Here is where functional spillovers, and associated proposals for future institutional reform, come back in.

Financial crises in the past certainly did promote such solidarity *within* many civil societies, and the modern state itself is the outcome. Something akin to this kind of development is arguably occurring right now within the eurozone, as financial crisis forges just enough of a sense of solidarity--a wide enough realization of 'shared fate'--to sustain an evolving regional capacity for crisis resolution.[44] The European System of Central Banks coordinated by the European Central Bank is already playing its part, and so is a more ambitious plan for identifying and limiting excessive national fiscal deficits. But state-like instruments hardly signal the only imaginable pathway to an adequate-enough capacity for resolution. Even within the eurozone, there is no shortage of good ideas for pragmatic substitutes for a still-infeasible European finance ministry. The most palatable include collective insurance programs.[45]

A new experiment along this line lies at the heart of the regional plan affirmed early in 2014 by the European Commission, the Council, and the Parliament to establish a Single Resolution Mechanism (SRM) for important cross-border banks. The plan builds on the 2012 assignment to the ECB of overarching supervisory responsibilities for those banks, after a near-term clean-up of troubled balance sheets. A Single Resolution Fund (SRF) will gradually be financed by national levies on the banks and then by mutualizing 60% of the resulting pools. The common fund of the European Stability Mechanism, a fund created mainly by government-backed bonds floated in private markets around the world, is already in place to back up the SRF; it is able to be expanded as and when required. Although the SRM still implies no common finance ministry, it does incline the regional emergency management system in the direction of more deeply coordinated fiscal responses when warranted. In the absence of such coordination, there would be little hope of actually preventing the single financial market, a longstanding EU objective, from fragmenting completely along national lines. Indeed, the urge to stop the fragmentation witnessed after 2008 provided the impetus for the new scheme.[46]

[44] In precisely this context, Frank Schimmelfennig provides a compelling defense of neofunctionalism. See "European Integration in the Euro Crisis: The Limits of Postfunctionalism,"*Journal of European Integration*, vol. 36, no. 3, 2014, pp. 321-337.

[45] See, for example, Henrik Enderlein, Lucas Guttenberg, and Jann Spiess, "Blueprint for Cyclical Shock Insurance in the Euro Area," *Notre Europe Papers*, Jacques Delors Institute, September 2013. Nicolas Véron perceptively sees these complicated moves toward a coherent region-wide banking policy as the politically feasible step when the option of fiscal union remained off the table. See his "European Banking Union: Current Outlook and Short-Term Choices," Statement presented at the conference "Banking Union and the Financing of the Portuguese Economy," Assembleia da Republica/Portuguese Parliament, Lisbon, February 26, 2014.

[46] There is, no doubt, a certain irony in the fact that German resistance to fiscal transfers during the recent crisis (and insistence that austerity marked the route out of crisis for the most troubled members of the eurozone) contributed to fragmenting tendencies within the European single market and is now matched by apparent German support for a long-term, insurance-based system designed to prevent future crises and to counter the momentum of market

An analogous global experiment looks more distant, but related developments are not absent. Before the crisis of 2008, as noted above, crucial policy debates on the resolution issue revolved around the theory and practice of sovereign bankruptcy. Serious reform proposals were conventionally grouped into three main categories: the unilateral, the multilateral, and the supranational.[47] In the first category, both conservative believers in the virtues of unfettered markets and the defenders of absolute sovereignty in developing countries joined in a common cause. Crises, when they occurred, were to be managed by unlucky or unwise external investors taking their lumps, and by debtor governments reverting to defaults and/or capital controls, notwithstanding attendant risks to their future access to external financing. In less extreme circumstances, private creditors and debtors would be left to their own devices to work out debt restructuring arrangements.

At the other end of the imagined policy spectrum were global institutions that would come closer to serving as the functional equivalents of domestic emergency-lending, bankruptcy, and liquidation arrangements. Two successive deputy managing directors of the IMF made such proposals, one for the Fund to be legally empowered to play the role of global lender-of-last-resort and the other for the Fund to serve as a kind of bankruptcy court by overseeing a Sovereign Debt Restructuring Mechanism.[48] Even in the aftermath of systemic crises in the 1980s and 1990s, neither proved politically acceptable. What did sometimes prove feasible, however, were market practices linking new debt obligations to one another in order to encourage multilateral cooperation among bondholders in future debt restructurings.[49]

The crisis of 2008 dramatically raised the stakes. Again as we have seen, however, unilateral and informally coordinated measures to manage the systemic effects of near-catastrophe bore the brunt of the actual burden of crisis management. Spreading contagion was finally stopped by collaborative but *ad hoc* arrangements among central banks and governments at the core of the

fragmentation. My own understanding is that this quite dramatically signals a longstanding quandary within German society itself. Support for the idea of 'ever closer union' in a European economic and political space of significant long-term benefit to key German interests goes hand-in-hand with an increasing reluctance to subsidize EU members perceived to be unable to adjust effectively to regional and global competitive pressures. A similar tension has long been evident within Germany on the issue of transfers from richer to poorer Länder. Deepening internal political complexity needs to be viewed as a starting point for analysis, not an end-point.

[47] Barry Eichengreen, *Capital Flows and Crises*, Cambridge, MA: MIT Press, 2003; Edward Truman, ed., *Reforming the IMF for the 21st Century* . Washington, DC: Peterson Institute for International Economics, 2006; Ralph Bryant, *Turbulent Waters: Cross-Border Finance and International Governance*, Washington, DC: Brookings Institution, 2003; Charles Goodhart and G. Illing, eds., *Financial Crises, Contagion, and the Lender of Last Resort*, Oxford: Oxford University Press, 2002.

[48] Eric Helleiner, "The Mystery of the Missing Sovereign Debt Restructuring Mechanism," *Contributions to Political Economy*, vol. 27, iss. 1, pp. 91-113.

[49] Chris Brummer, *Soft Law and the Global Financial System*, Cambridge: Cambridge University Press, 2012.

system.[50] Those arrangements stopped short of establishing definitive resolution mechanisms for the future, but they did stimulate new work in various forums for post-crisis risks assessment and future crisis prevention. Indeed, we can see that a few signal experiments are now being designed, including one focused on forcing cross-border banks, in consultation with their supervisory colleges, to make reasonable arrangements for their own funerals.[51]

The way the crisis of 2008 was actually managed did, nevertheless, heighten market expectations that systemically significant financial institutions, and that the larger experiment in global integration they represented, would persist. That this translates into implicit subsidies for those institutions, especially during emergencies but also in 'normal' times, would now become obvious.[52] That those subsidies may also once again encourage imprudent risk-taking and render global markets more not less fragile has also led governments (and organized interest groups) straight back to the agenda of global risk measurement and crisis prevention. Here is the essence of functional spillover. The path ahead is filled with moral hazards and other significant political complexity, but the path back looks blocked by the institutional consequences of prior policy decisions.

Understanding full well the implications for their fiscal accounts if they could not come up with prompt and effective risk assessment and crisis prevention measures, those same governments are now trying to revive market discipline by ostensibly making it more difficult to organize bailouts the next time. The US Treasury and the Federal Reserve, for example, sensed manifold domestic and international pressures that may complicate, or even preclude, the kinds of measures they took in 2008. 'Saving' big domestic <u>and</u> foreign banks from the consequences of their own mistakes was never going to be popular, even if the alternative seemed worse at the

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[50] That those governments ranked high in the global hierarchy of power is obvious, just as it is hierarchy, not monarchy or anarchy, that is the relevant systemic descriptor at this moment in history in this policy arena. See David A. Lake, *Hierarchy in International Relations*, Ithaca: Cornell University Press, 2009; Pauly, "The Old and the New Politics of Financial Stability," *Journal of Common Market Studies*, vol. 47, no. 5, 2009, pp. 955-975; and Dirk Schoenmaker, "The Quest for Financial Stability in Europe," Utrecht, SUERF Colloquium, 3 September 2009

[51] "The Dodd-Frank Wall Street Reform and Consumer Protection Act requires that bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve periodically submit resolution plans to the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). Each plan, commonly known as a living will, must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company, and include both a public and confidential section." Federal Reserve Board of Governors website, http://www.federalreserve.gov/bankinforeg/resolution-plans.htm, accessed May 1, 2014. For illuminating background, see Kathryn C. Lavelle, *Money and Banks in the American Political System*, Cambridge: Cambridge University Press, 2013; and Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton: Princeton University Press, 2014. For an assessment of the practical implications of living wills, see Emilios Avgouleas, Charles Goodhart, Dirk Schoenmaker, "Bank Resolution Plans as a catalyst for global financial reform," *Journal of Financial Stability*, vol. 9, iss. 2, 2013, pp. 210-218.

[52] "In dollar terms, if applied at the total liabilities of the banks [designated by the FSB as global systemically important]net of equity, the implicit subsidies in 2011-12 represent around $15-70 billion in the United States, $25-110 billion in Japan, $20-110 billion in the United Kingdom, and up to $90-300 billion in the euro area." IMF, *Global Financial Stability Report*, Washington, DC: International Monetary Fund, April 2014, p. 104.

time. In such a context, we might have some sympathy for Fed officials who tried to hold back the 'never again' pressures from Congress by setting out detailed warnings to foreign governments and foreign banks not to count on future liquidity support from the United States. As Fed governor Dan Tarullo put it recently, "There must be some assurance beyond mere words from parent banks or home-country supervisors that a large foreign banking organization will remain strong or supported in periods of stress."[53] Fair enough, but observers will be forgiven for playing out the game of chicken in their heads and doubting that the lead player is really willing to throw away his proven tools for self-interested crisis management. Indeed, although responsive policy coordination had an *ad hoc* character last time, global market participants would reasonably calculate the probability of its future repetition as quite high.

The credible prospect of catastrophic loss was enough to motivate just-adequate systemic crisis management in 2008. The prospect of future joint gains is a less reliable motivator for building a solid institutional replacement or resolution mechanism. Global regulation is now logically required by the continuing existence and expansion of systemically significant financial institutions, but, as memories fade, support seems only to be mustered for adjustments in technical policies aimed mainly at re-assessing risks and bolstering preventive measures. This explains the more focused and detailed mission the G20 club has assigned to the Financial Stability Board (FSB), the proliferation of standard-setting efforts across a wide range of financial sub-sectors, the increasing prominence of the now-larger club of central banks signified by their bi-monthly meetings at the Bank for International Settlements, and the enhancement of the role of the IMF and the World Bank in monitoring systemic risks and assisting weaker states.[54]

In this sense, the transnational 'prevention' state, shaped by underlying conflicts but seemingly destined to persist, continues on its evolutionary, if hardy smooth or inevitable, path. The capacity to deal with global financial risk is being built, but transnational resolution authority in some form will eventually be required. At a time when political power is shifting underneath a globalizing economy, the logic of functional spillovers here meets the hard politics of establishing robust and legitimate governing structures. New governmental arrangements are evolving.

[53] Daniel K. Tarullo, "Regulating Large Foreign Banking Organizations," Harvard Law School Symposium on Building the Financial System of the Twenty-first Century: An Agenda for Europe and the United States, March 27, 2014. (After a major fire, an exhausted fireman may be tempted to warn a home-owner saved this time by his efforts never to expect the same again. 'Be more careful in the future, he might say. Look, I have replaced my big hose with a garden hose. I can't promise to save you again! You will have to be more prudent!' The home-owner may well agree, but he will also surely now believe that the big hose cannot really be far away. LP)

[54] Stephany Griffith-Jones, Eric Helleiner and Ngaire Woods, eds., *The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance?* Waterloo, ON: Centre for International Governance Innovation, 2010, pp. 13-18. On the IMF, see Jeffrey M. Chwieroth, *Capital Ideas: The IMF and the Rise of Financial Liberalization*, Princeton: Princeton University Press, 2010. Note that the construction of a bridge between prudential policy-making and macroeconomic policy-making at the system level began in 1999 with the Financial Sector Assessment Program of the Fund and the World Bank.

The system inclines toward more complex interdependence and more difficult political conflict, and nothing is certain. But there is still no good reason uncertainty should incline us away from faith in the future.

IV. A Speculative Coda

When calculable risks in globalizing markets next threaten to be overwhelmed by radical uncertainty, the expectation that relevant governments will collaborate will be more obvious than ever. But clarity is not necessarily 'good' in a dynamic and conflictual political setting. The case history surveyed briefly in this paper suggests the need slightly to modify Kindleberger's well-known proposition. Required in today's systemic financial emergencies is a capable leader and an adequate network of followers, all of whom may continue to need plausible grounds for denying that burden sharing is the intent of their interdependent decisions. Essential is the habit of collaboration, which increasingly extends from monetary and liquidity matters to definitive fiscal measures. In democratic polities such as they are now structured and limited, what can undercut the ability of leaders to lead and followers to follow? What can undermine the practice of collaboratively breaching the bulwarks of fiscal sovereignty when dangers loom? Perhaps too much clarity too soon. Until 'democracy beyond the state' can provide a robust sense of legitimacy to effective transnational governing capacities, we may well be left with 'assertive governance' and purposive ambiguity at moments of systemic crisis.[55] Stephen Krasner made the convincing case that state sovereignty itself was always an 'organized hypocrisy.'[56] For the time being, the evolving practice of systemic crisis management, may justify the same label. Conflict is sure to remain, but so eventually may legitimation develop as experiments in risk governance continue eroding the boundaries around existing zones of communal solidarity.[57] The capacity for collaborative risk assessment and crisis prevention is developing through the logic of experimentalism. So too is the capacity for emergency management. It is the legitimacy of final resolution instruments that continues to pose the deepest questions.

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[55] Michael Th. Greven and Louis Pauly, eds., *Democracy beyond the State? The European Dilemma and the Emerging Global Order.* Lanham, MD: Rowman & Littlefield Publishers/Toronto: University of Toronto Press, 2000; and Fritz Scharpf, *Governing in Europe: Effective and Democratic?* Oxford: Oxford University Press, 1999.

[56] Stephen D. Krasner, *Sovereignty: Organized Hypocrisy*, Princeton: Princeton University Press, 1999.

[57] For related debate, see Edgar Grande, 'Cosmopolitan Political Science,' *British Journal of Political Science* 57(1), 2006, pp. 87-111; Michael Th. Greven, 'The Informalization of Transnational Governance: A Threat to Democratic Government", in Grande and Pauly, eds., *Complex Sovereignty*, Toronto: University of Toronto Press, 2005; and Rod B. Hall and Thomas Biersteker, T.J., eds., *The Emergence of Private Authority in Global Governance,* Cambridge: Cambridge University Press, 2002; Mathias Koenig-Archibugi and Michael Zürn, *New Modes of Governance in the Global System*, Basingstoke: Palgrave Macmillan, 2006. More recently, Zürn describes in a recent paper, "From Rule to Authority," the emerging system of governance as one characterized by 'loosely coupled spheres of authority.'

Unless or until fiscal authority moves to the level implied by globalizing markets, effective policy capacity and durable political legitimation will remain in profound tension. Experimentalism is indeed the order of the day, and institutional innovations like the Basel Process may for a time help us live with such tensions. So too might an expansion in the kinds of cross-national risk pools public and private insurance systems can facilitate. Although straightforward *ex ante* burden-sharing agreements remain elusive, repeated *ad hoc* arrangements during and after crises do certainly give rise to reasonable expectations of future regulatory, monetary, and fiscal coordination.

The anticipation and resolution of financial crises look set to define arenas where seriously creative politics will remain required. Who among us would contend that human beings in increasingly complex social relationships with one another on a global scale cannot live with such tensions or with such politics? That we are left with difficult normative, moral, and distributive questions is undeniable. If we are lucky, we can together provide good answers just as those structures are consolidated.

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